

## **SPEECH BEFORE THE NATIONAL ORGANIZATION OF INVESTMENT PROFESSIONALS**

U.S. Senator Edward E. Kaufman

April 20, 2010

It is a great pleasure to address the spring conference of the National Organization of Investment Professionals. Your members are the very heart and soul of our capital markets.

I've been a Senator since January, 2009, a month in which 700,000 Americans lost their jobs due to the recent financial crisis and the great recession that followed.

And I think it's fair to say that in the past 15 months, I've spent more time on Wall Street reform, on pushing the Securities and Exchange Commission and my Senate colleagues to do more, than on any other set of issues.

Why? Because I believe at my core that the two strongest pillars on which our great nation rests are democracy and our capital markets. And the credibility of our markets has been badly damaged.

Let's not kid ourselves. It has been badly damaged, and we must work together to restore it and ensure that we don't have another crisis that damages it further still.

Together, all of us in this room should agree on at least one thing: Our capital markets are a crown jewel. We must preserve their credibility and integrity if investors are to have confidence, if our nation is to prosper, and if our grandchildren are to live in the economically strongest country in the world.

I know you all feel like you work in a highly regulated environment. If you could, you would no doubt like to corner me after this speech and tell me about all the rules and paperwork and audits and examinations that each of you and your firms must endure.

That may be the case. But something is nonetheless deeply, deeply amiss.

To the rest of America, it appears that Wall Street's entire culture has descended in a spiral of greed and corruption. And they feel that spiral came very close to taking the rest of the country down with it.

Take the charges leveled last week by the SEC against Goldman Sachs and one of its traders for allegedly defrauding investors by failing to disclose conflicts of interests in collateralized debt obligations.

Take the Lehman Brother's bankruptcy examiner's report, which exposed the use of Repo 105's. That report documents what appears to have been outright fraud, by Lehman, its management and its accounting firm —hiding \$50 billion in liabilities at quarter's end to "window dress" its balance sheet. And this practice was not unique to Lehman Brothers.

Take the hearings underway in the Permanent Subcommittee on Investigations, where Chairman Levin has uncovered a stunning array of potential mortgage origination fraud and fraud in the securitization of those mortgages by Washington Mutual. This led to the largest bank failure in U.S. history.

Take the Financial Crisis Inquiry Commission and its deconstruction of the ineptness at Citigroup, which lost hundreds of billions of dollars in shareholder value while its executives were paid hundreds of millions of dollars.

If you really want to know the causes of the financial crisis and what many believe we must do about it, then read *13 Bankers* by Simon Johnson and James Kwak. It lays out in disturbing detail what happened along with *The Big Short* by Michael Lewis, *Too Big to Fail* by Andrew Ross Sorkin, and *The Quants* by Scott Patterson. These books give a well-sourced autopsy of the financial crisis that is shocking Americans with a view of Wall Street practices that clearly have gotten completely out of hand.

The over-the-counter derivatives market and the development of credit default swaps and collateralized debt obligations and how they metastasized into what Warren Buffet has called “financial weapons of mass destruction” will soon become a chapter in our high school history books. With Washington’s help, Wall Street developed a derivatives market so opaque and unregulated, where no due diligence of counterparties took place, where the credit rating agencies were dupes and easily manipulated by Wall Street actors, that it brought us to the brink of global financial collapse. And all the while Wall Street actors raked in billions of dollars in fees.

And that doesn’t even include the many dramatic changes in market structure, including my pet project, high frequency trading, which is opaque and for all intents and purposes operates outside the current regulatory umbrella. There is nothing wrong with the advance of technology. That is inevitable and usually positive.

But in my view we have a “wild west” trading environment in equities, options and other markets where algorithms are battling algorithms, with no transparency or understanding at the SEC. The SEC therefore has no ability to detect and police manipulative strategies. It’s not enough to rely on agency brokers to protect customer orders. We need surveillance and enforcement for investors to have confidence.

Quite simply, all of these problems in my view can be traced directly to the deregulatory mindset that captured Washington and our regulatory agencies over the past 30 years. We became enamored of the view that self-regulation was all we need.

That “rational” self-interest would motivate counterparties to undertake stronger and better forms of due diligence than any regulator could perform. That market fundamentalism would lead to the best outcomes for the most people. The allure of deregulation, instead, led to the biggest financial crisis since 1929.

And now we’re learning, not surprisingly, that fraud and lawlessness were key ingredients in the collapse as well.

Since the fall of 2008, Congress, the Federal Reserve and the American taxpayer have had to step into the breach – at a direct cost of more than \$2.5 trillion – because, as so many experts have said: “We had to save the system.”

But what exactly did we save?

First, a system of overwhelming and concentrated financial power that has become dangerous. It helped cause the crisis of 2008-2009 and threatens to cause another major crisis if we do not enact fundamental reforms.

Only six U.S. banks control assets equal to 63 percent of the nation’s gross domestic product. Just 15 years ago, the assets of the six largest U.S. banks represented 17 percent of GDP.

At the same time, oversight is splintered among various regulators who are often overmatched in assessing weaknesses at these firms.

Second, a system in which the rule of law has eroded yet again.

What lessons should we take from Goldman Sachs, Washington Mutual, Citigroup, the bankruptcy examiner's report on Lehman, and other recent examples of allegations of misleading conduct on Wall Street?

I see three.

First, we must undo the damage done by decades of deregulation.

That damage includes financial institutions that are “too big to manage and too big to regulate,” as former FDIC Chairman Bill Isaac has called them.

It also includes a system with rampant conflicts of interest that can lead to fraudulent behavior. And it includes colossal failures by accountants and lawyers who misunderstand or disregard their role as gatekeepers.

The rule of law depends in part on manageably-sized institutions, resolving conflicts of interest, participants interested in following the law, and gatekeepers motivated by more than a paycheck from their clients.

Second, we must help regulators and other gatekeepers by demanding transparency and by providing clear, enforceable “rules of the road” wherever possible.

That includes most especially bringing transparency and mandatory clearing to the derivatives market, and transparency and active regulatory surveillance of high frequency trading activities.

Third, we must concentrate law enforcement and regulatory resources on restoring the rule of law to Wall Street.

We must treat financial crimes with the same gravity as other crimes, because the price of inaction and a failure to deter future misconduct is enormous.

The bottom line is that this nation has learned a hard lesson: whenever there is a lot of money surging into a risky area, where change in the market is dramatic, where there is no transparency and therefore no effective regulation, we have a prescription for disaster.

Most certainly, it is a prescription for a loss of investor confidence and a weakening of our markets' credibility.

Let me elaborate briefly on three areas: the current financial regulatory reform bill before the Senate, the SEC review of high frequency trading, and law enforcement.

First, when it comes to the regulatory reform bill, I believe regulation can work, but not if we set regulators up for failure by asking them to oversee megabanks that have grown far too large in size, complexity and interconnectedness.

Congress needs to act decisively to end the boom-bust-bailout cycle now.

There's a time for Congress to defer to regulators, and there's a time for Congress to use statutes to draw hard lines and erect walls. This is a time for hard lines and high walls.

Out of the ashes of the Great Depression, we built a legal and regulatory edifice that endured for decades.

The cornerstone of that edifice was the Glass-Steagall Act. It established a federally guaranteed insurance fund to back up bank deposits while also putting in place a firewall between commercial

and investment banking activities. Other rules were imposed on investors to tamp down rampant speculation, like margin requirements and the uptick rule on short selling.

These edifices, established in the 1930's, served us well into the 1980's. And then – as I said before – we dismantled them piece by piece, leading to our present predicament.

The single most important thing we can do to ensure that such a financial tragedy does not happen again is to split up our six largest financial institutions into commercial banks and investment houses and impose size caps on both.

Unfortunately, the financial reform bill now under consideration in the Senate does not call for this structural reform.

The bill does not include a return to the Glass-Steagall separation of commercial and investment activities, which has bipartisan support including Senators Maria Cantwell, John McCain and a growing number of other colleagues.

The bill asks a Financial Stability Oversight Council to “study” the effects of the proposed Volcker Rule prohibition and make “modifications” that the Fed can impose by rule. In the end, the council could issue a recommendation not to enforce the Volcker Rule at all or a watered-down version in which regulators mandate capital requirements that would permit any risky proprietary activities a particular bank might undertake.

Finally, the bill establishes a resolution authority, designed to help resolve failing institutions. But it is hard to picture an orderly and successful wind-down of a \$2-trillion financial institution that has hundreds of billions of dollars of off-balance-sheet assets, relies heavily on wholesale funding, and has operations in over 100 countries. Even more problematic, we're nowhere near having the

sorts of cross-border resolution agreements necessary to make orderly resolution plausible.

When mega-banks fail, their interconnected nature inevitably leads to a systemic risk, a collapse in confidence and the classic patterns of a bank run. By splitting up these mega-banks, we by definition will make them smaller, safer, and more manageable. This is a debate I will continue to push on the Senate floor.

Let me turn to the SEC's review of high frequency trading.

As many of you know, for months I have urged the SEC to issue a proposed rule to tag high frequency traders over a certain volume threshold and collect the data. Last week, the five Commissioners voted unanimously to adopt such a rule proposal that for the first time should help regulators gain a better understanding of the complex and largely-opaque high frequency trading strategies that now dominate the equities markets.

I believe the proposed rule marks an important step toward ensuring that the Commission has the data it needs to analyze and understand high frequency trading strategies and detect any market abuses that disadvantage long-term investors. But requiring broker-dealers to collect the data and having the Commission examine it effectively are two different things. We need active regulators and surveillance, not a passive system that permits data to pile-up in back offices.

For that reason, I believe random samples of the data should be collected by the Commission and thoroughly analyzed by the Commission or FINRA, so that the Commission can say definitively that certain trading patterns – if the requisite element of intent can be shown – constitute illegal manipulation.



Moreover, some of this data, in concealed form, should be released to the media and general public – or at least to academics and private analytic firms under “hold confidential” agreements – so that independent analysts can assist the Commission in detecting illegal activity.

It is time to end an environment in which high frequency trading firms are unbounded by effective surveillance and the possible detection of any manipulative trading strategies.

Finally, when it comes to policing the capital markets, I am optimistic that the future of law enforcement will be different. Already, new regulators are in place — sending a message that the cops are back on the beat.

I know that the vast majority of people who work in the capital markets are honest. However, we must restore the public's faith in our financial markets and the rule of law.

The Goldman Sachs case has spawned a huge amount of commentary. I do not sit in judgment of any particular case. That is for prosecutors, judges and juries to decide.

But I believe strongly the SEC and the Justice Department must identify, prosecute, and fine or send to prison the participants in those markets who broke the law. Their fraudulent conduct has severely damaged our economy, caused devastating and sustained harm to countless hard-working Americans, and contributed to the widespread view that Wall Street does not play by the same rules as Main Street.

I co-authored the Fraud Enforcement Recovery Act with Democratic Senator Pat Leahy and Republican Senator Chuck Grassley. President Obama signed the bill into law last May. It

ensures that additional tools and resources will be provided to those charged with enforcing our nation's laws against financial fraud.

Some have said we should not seek to "punish" anyone because all of Wall Street was in a delirium of profit-making — and almost no one foresaw the sub-prime crisis caused by the dramatic decline in housing values. Let me be clear: this is not about retribution. This is about addressing the continuum of behavior that took place — some of it fraudulent and illegal — and in the process addressing what Wall Street and the legal and regulatory system underlying its behavior have become. If individuals and entities broke the law in the lead up to the 2008 financial crisis, there should be civil and criminal cases that hold them accountable.

As I said more than a year ago: "At the end of the day, this is a test of whether we have one justice system in this country or two. If we don't treat a Wall Street firm that defrauded investors of millions of dollars the same way we treat someone who stole 500 dollars from a cash register, then how can we expect our citizens to have faith in the rule of law? For our economy to work for all Americans, investors must have confidence in the honest and open functioning of our financial markets. Our markets can only flourish when Americans again trust that they are fair, transparent, and accountable to the laws."

This speech to you today has included some tough words. And we'll see if they're followed by action. But my concluding message is that you should join me in this effort, for the success of your industry, and of this nation, depend on it.

We all must work together, in the interests of liquidity, efficiency, transparency and fairness to ensure our markets are the strongest and best-regulated in the world. But we cannot have one without the other — for markets to be strong, they must be credible.

So with this reality in mind, I look forward to working with my colleagues, regulatory agencies, and people from across the financial industry to ensure our markets are free, credible and the envy of the world.